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CURRENCIES AND CREDIT MARKETS

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"Working and saving are a totally outmoded ethic during the latter stages of the boom. What was previously considered speculative is treated as sound investment. People have very little interest in long-term savings or anything else that fails to provide instant gratification."

Robert Beckman, Crashes, p.8
Grafton Books, London

HIGHLIGHTS

The world's financial mania has entered the "feeding frenzy" stage. It has become a monster. How long will it last? Can the authorities tame it and prevent a bust? While the timing may be unknown, the final outcome couldn't be more certain — a bust that will play havoc with world financial markets and economies.

Never before has the world witnessed a global mania of the proportions we are seeing now. Never has a financial mania existed in such contrast to underlying economic conditions.

The sophists of today — the economists, traders and the media — have been as ingenious as never before in providing a false psychological catalyst to the boom . . . luring the masses by illuminating a new golden, glorious pathway to prosperity.

It's clear that U.S. money flows are the big force behind the mania. Interest rate trends — specifically cuts by the Bank of Japan and the Bundesbank — helped turn up the heat as well.

There are three different scenarios for the future of financial markets. Which one to believe? We're in the minority camp — those that worry about a great deflationary spiral.

The illusion is that an ocean of excess liquidity is flooding the markets. To stress again, it's not abundant liquidity but abandoned liquidity that's driving the financial boom. When the music finally stops, there won't be enough chairs.

We see two great paradoxes in the currency markets that are ripe for reversal. Unsustainable developments affect both the dollar and the yen. These are liable to abrupt change. We explain the implications for both currencies.

On the economic front, the world today is experiencing neither textbook recessions nor textbook recoveries. Weak cyclical forces are still being dwarfed by the heavy structural maladjustments and imbalances that are the lagging legacies of the excesses of the 1980s.

There is no strong investment spending recovery in the U.S. or anywhere else for that matter. Neither is one expected. That portends a renewed slowdown in the U.S. and continuing economic weakness around the globe.

Given the inordinate risks, we see little worthwhile investment opportunities. Investors should only focus on cash securities and the shorter-term bonds of the hard currency countries.

THE FINAL CRESCENDO?

Just as we go to press, the U.S. Fed announced that it is raising its Fed funds rate one-quarter percentage point to 3.25%. What to make of it? Is it a signal of a tightening monetary policy? No. We think it is a calculated move by the Fed that's in concert with the desires of the major players and beneficiaries of the financial bubble. Although the Fed may couch its move under the guise of protecting its inflation integrity, it's really a move designed to preserve the speculative mania. It's monetary voodoo and displays an ignorance of the dangers of a financial mania and a weak economy. It signals that financial markets have entered an environment of extreme risk.

In recent months, "animal spirits" have given a further impetus to the unfolding global market mania. The reasons are secondary to the momentum of the mania itself. On Wall street, markets cheer emerging economic strength. In Europe, the expectation of falling interest rates, specifically because of weak economies, is the bullish catalyst. Whatever happens — strength, weakness — it's rationalized as being bullish for financial markets. In the U.S. and elsewhere, the equity mutual fund "feeding frenzy" continues at manic levels further heating the mania. In December alone, these funds pulled in $14.5 billion in the U.S. bringing the 1993 total to a record $128 billion. The mania is becoming a monster. Will the Fed be able to tame it?

A WILD WEST IN CAPITAL FLOWS

Clearly, the epicentre of the world financial mania is in the United States. During 1993, and especially during the fourth quarter, American money flooded into world financial markets in record volumes. While Japanese stocks slumped in the fourth quarter and U.S. equities only inched up a mere 2%, European stocks leapt ahead with an average gain of 9%. The dazzling stars were the Far Eastern "Tiger"countries. Stock markets in these countries rocketed up by an average of 50% during the last three months of 1993.

One wonders what might have prompted this frenzy so suddenly. We see three chief reasons, all of them directly related to interest rates trends. The biggest cause was ballooning U.S. portfolio outflows. The flight of U.S. investors and savers out of low-yielding U.S. bank deposits and into bond and equity funds spilled over into foreign markets. More than half of equity mutual fund purchases in recent months in the U.S. have headed for far shores.

Secondly, the sharp interest rate cuts by the Bank of Japan on September 21st of last year provided an additional push. In response to continuing economic weakness, the central bank cut its discount rate to 1.75% from 2.5%. Short-term rates below 2.0% and long-term rates declining to near 3% levels triggered soaring portfolio outflows. This money largely went into the "Tiger" markets such as Malaysia, Thailand and Singapore, not to mention Hong Kong. And voila, these relatively small, illiquid markets catapulted upwards by as much as 50% in the fourth quarter alone.

A third influence was the Bundesbank. In quick succession, it cut interest rates in late September and again in early October surprising the markets and arousing expectations of bolder action on German and European interest rates in the future. It harmed the D-mark and ignited the European securities markets.

U.S. MONEY FLOODS THE WORLD FINANCIAL MARKETS

U.S. money has had a big impact on markets everywhere. During the first nine months of 1993, U.S. net portfolio outflows amounted to a staggering $99.3 billion. In the third quarter alone, these outflows shot up to an annualized rate of more than $185 billion. By comparison, in the mid-1980s — the previous

period of cheap U.S. money — net portfolio outflows amounted to only $6-8 billion per annum. Presently, it only takes two weeks for this much to flow out.

The figures we cited for last year are only net amounts. It doesn't reveal the heavy churning that goes on underneath. During the first nine months of 1993, total buying and selling of foreign stocks by U.S. residents totalled $370 billion. The same figure for foreign bonds was a staggering $1.2 trillion.

What boggles the mind is the fact that everybody keeps forecasting a rising dollar even though U.S. portfolio capital outflows are soaring on top of a rising U.S. current-account deficit in excess of $100 billion at an annual rate, up from $66.4 billion for all of 1992.

U.S. PORTFOLIO OUTFLOWS AND CURRENT ACCOUNT DEFICITS
Billions of Dollars

	1991	1992	1993*	1Q	2Q	3Q
Net Stock Purchases	32.0	32.3	47.7	8.9	14.1	25.0
Net Bond Purchases	14.8	19.6	51.6	15.2	12.0	21.4
Total Purchases	46.8	51.9	99.3	24.1	26.1	46.4
Current Account Deficit	8.3	66.4	77.5	22.3	27.2	28.0
Annualized Payment Deficit	55.1	118.3	235.7	185.6	213.2	297.6

* January to September

Observing the enormous U.S. dollar flows flooding into the rest of the world in spite of the huge U.S. current account deficit (as shown in the above table), we ask ourselves this critical question: Just who is financing this international deluge of dollars in such abundance that it actually buoyed the dollar? Outside of U.S. export earnings, we see five potential major sources of dollar demand in the foreign exchange markets: 1) foreign central banks; 2) foreign purchasers of U.S. stocks and bonds; 3) short-term "hot money" that's speculating on a rising dollar; 4) the hedging of investment portfolio capital; and 5) changes in the timing of payment for U.S. exports and imports (so-called leads and lags).

In 1993, foreign central banks bought about $60 billion in U.S. dollars, a large amount by their standard. The Bank of Japan accounted for almost half of this figure. Non-resident purchases of U.S. stocks and bonds during the first nine months of 1993 amounted to about another $60 billion. However that inflow was far below U.S. portfolio outflows of $99.3 billion as the above table shows.

Given a huge current account deficit of approximately $100 billion, there is a huge gap in the U.S. balance of payments of more than $70 billion. Yet, the dollar rose . . . though, much less than the dollar bulls had been predicting. Where did this money come from?

In short, the dollar gap must have been filled by short-term speculative money, investment hedging and changes in terms of payment. When currency speculation becomes one-sided, these three sources of currency transactions surge in favour of the currency that is believed to be appreciation-prone. Given the deafening, virtually-unanimous forecasts for a rising dollar, this is exactly what happened. In recent years, portfolio transactions have become particularly influential in determining the trends of currency markets. What we see is nothing more than the self-fulfilment of the dollar forecasts. The point to see is that this can only boost a currency for so long.

It's really bizarre when you think of it: U.S. investors are dumping dollar balances in a desperate search for higher yields and returns. On the other side, currency speculators are pouring into the low yielding dollar balances betting that a rise in U.S. short-term rates will reward them with currency gains on the dollar. Somebody must be awfully wrong.

JAPANESE CAPITAL OUTFLOWS: THE OTHER WILD CARD

Japan and its yen are the opposite paradox to the U.S. and the dollar. Last year, Japan ran a record-high current account surplus of $140 billion. At the same time, its private portfolio outflows virtually halted. As the yen pushed upward, the Bank of Japan intervened heavily in the foreign exchange markets, boosting its dollar reserves from $27 billion to $95 billion between January and September last year. These balances, habitually, are invested in U.S. Treasury paper.

Yet, irrespective of this huge structural current account surplus, the consensus view is that the yen is destined to fall against the dollar. Behind this view are two favourite arguments: firstly, that Japan's economy is in a ghastly mess in comparison to the U.S. economy; and secondly, that the yen is grossly overvalued in purchasing power terms. Incidentally, these are the same reasons cited for D-mark weakness.

Taking this perspective, there seemingly must exist a mysterious, direct connection between relative GDP growth and currency movements. Such elements as an immense surplus in Japan's current account apparently don't matter in this analysis.

Over recent years, Japan's international recycling of its current surplus has worked out quite smoothly, at least so far. But it's important to realize that this was due to a special, temporary factor which is coming to an end. During the "bubble" years of the later 1980s, Japanese banks and corporations invested money abroad, far in excess of the country's current surplus. In doing so, they borrowed hundreds of billions of dollars, piling up a fast foreign indebtedness mainly in the Euro-markets.

This mountain of foreign debt is actually the main reason why Japan was able to so easily dispose of its cumulative $340 billion surplus over the past three years. This surplus was used to pay back the debts. But given the rapid repayment, this convenient outlet for the surplus has since largely been exhausted.

Now Japan's problem begins in earnest. It has to find another way of disposing it's surplus. Will Japan's banks, corporations and investors embark on a new international investment binge? Or will Japan's gigantic surplus collapse for some unforeseeable reason? Whatever the case, we think Japan will be a wild card for the currency and financial markets.

LIQUIDITY ILLUSIONS

Looking at the huge frenetic flow of cross-border capital which is buoying the financial markets, we are sure of at least one thing: Flows of this size are unsustainable, not to mention unpredictable. Our dissent with the euphoric consensus view starts with a contrary interpretation of the inherent liquidity conditions.

The bullish story, happily received by virtually everyone, is that an ocean of excess liquidity is flooding the markets. Given the general economic sluggishness in the major industrial nations, so the popular rationale, the money has nowhere else to go but into financial assets. The truth is otherwise as we've explained before in past letters. Measured by broad money, actual liquidity trends are the worst they've been during the entire postwar period. At work, instead, is a massive asset shift, a flight from low-yielding bank money into securities.

The flows resulting from this enormous asset-mix shift are obviously creating an illusion of unlimited

liquidity and capital. The flaw is this: Transactional volume is being confused for liquidity. Because of that, many so-called experts ignore low broad-money growth as irrelevant. Who cares if money growth is low if the stock and bond market volumes can easily facilitate large sales? This belief, as historians know, is a classic delusion. Securities are liquid only so long as markets continue to boom. What's truly driving the financial boom is not abundant liquidity but abandoned liquidity. When the music of the financial mania finally stops, there won't be enough chairs to go around. The jaws of the infamous "liquidity trap" will snap shut virtually overnight.

THREE POTENTIAL SCENARIOS

Ultimately, all of our concerns give rise to two big questions: Firstly, how long can this financial boom last? Secondly, how will it end? Basically, there are three main views.

The majority, as represented by the punch-drunk consensus, is convinced that the financial nirvana is here to stay. Most financial seers now predict conditions highly favourable to such a scenario well into the far future. It is not seen as a speculative bubble at all, but rather as a healthful, secular portfolio shift away from deposits and towards securities which is a natural reflection of a secular decline in inflation and interest rates. Meanwhile, outstanding profit prospects are believed to legitimize this rosy view. That summarizes the three touchstones of the prophets of boom: low inflation, low interest rates, and improving corporate profits. Delightfully, they all herald continuing increase and assure lofty valuations of financial assets as far as the eye can see.

There is a second camp that has a contrarian view to the first and has a following largely in the U.S. This group is on the watch for an inflation eruption. They point to the extreme money pumping of the Fed over the past few years and assume that, at some point, investors will switch over from overvalued financial assets to undervalued real assets. When that happens, they believe, it will launch an unbridled inflation in commodities and goods and services much as happened in the 1970s.

A third, motley contingent seems to have the fewest adherents though it does get serious attention in Japan presently. Its central and defining view is that the present world economic slump could degenerate into a vicious deflationary circle. According to their theories, the greatest threat to the world economy is the inevitable bursting of the financial bubble. We identify ourselves with this group.

That's three very different scenarios with radically different implications for the markets. Which one to believe? Markets, of course, are playing the first scenario for all its worth . . . at least for the time being. With the world economy entering its fifth year of sub-par growth, financial markets continue to be entranced with this scenario. Yet, it's a case never experienced before. During the stock market boom of the 1920s, the U.S. economy did very well until quite shortly before the crash. The same applied to Japan in the 1980s. Economic weakness was not seen as a cause for a financial boom.

CLUES TO THE LIKELY OUTCOME

In trying to deduce the endpoint of the present situation, we need to first identify its causes. The one key source of the present world financial boom is, of course, the Fed. By slashing short-term interest rates to the bone and flooding the banks with reserves, it turned up the heat by setting up the steepest, longest yield curve in modern history and literally chased money out of low-yielding deposits and into the securities. By now, that part of the saga is well known.

Yet, a central bank can't do this single-handedly. In addition to the supply of money, what's needed is a boom psychology . . . a mass belief. What's required are appealing stories and slogans that rationalize the current price rises and promise their continuation. The slogans vary from one boom to another but one mantra always recurs — that "*things are really different this time.*" The view is popularized that the new era has no prior comparison; that therefore valuation standards of the past no longer apply.

Having studied history, we must give credit where it is due. This time, the economists, traders and media, the financial sophists of the day who essentially contribute this psychological catalyst to the boom are ingenious as never before. In the past, economic sluggishness has always been seen for what it was — undesirable and bad. This time, these "spin doctors" have actually succeeded in making a virtue out of poor economic performance . . . a glorious pathway to prosperity. More than once recently, we have read that this is "*the best of possible worlds*" for the U.S. economy and its financial markets, indeed the world financial markets.

Here is an excerpt from the London Economist which is more or less characteristic of the present optimism about the U.S. and the U.K. economies (and incidentally, also reflective of the thinking in Australia and Canada): "*Despite the subdued nature of this economic recovery, profits have been booming in America and Britain...This year, if forecasts prove correct, profits as a percentage of GDP will reach their highest levels since the 1960s, and almost double their lows in the early 1980s...From the point of view of the economy as a whole, fatter profits are excellent news. Other things being equal, they will encourage firms to invest more, and to boost output and jobs. Likewise, a shift from consumption to investment will make recovery more sustainable by helping to keep inflation low as economic growth accelerates.*"

Taking this comment at face value, one would think that the U.S. and British economies were suddenly ebullient in economic health. In this view, the widespread corporate job shedding and restructuring is the great recipe working wonders on productivity, profits and future economic growth.

UNDERPERFORMING ECONOMIES EVERYWHERE

When reading such reports, we wonder what's missing? Is it analytical smarts or just plain old-fashioned honesty? As the last letter showed in detail, the current U.S. economic recovery has underperformed past business cycles in every way. The only aspect that looks better is inflation. But even this achievement loses much of its lustre when the economy's sluggishness and the exploding trade deficit are taken into account. In comparison to a dynamic, capacity-expanding economy that has low inflation mainly due to its high-productivity growth, low inflation in an economy that's under duress is nothing to cheer about.

It also boggles our mind how inflation rates of 2-3% can be treated as miraculous harbingers of economic growth and prosperity and be the justification for zero real interest rates and unprecedented high valuations of stocks and bonds. Equally ludicrous in our eyes is the general tendency to glorify the corporate "slash-and-burn" strategies of job shedding and downsizing as the key to sustainable, healthier and more profitable economic growth.

That's exactly what happened during the Great Depression of the 1930s. The difference then was that there wasn't a single economist in the whole world who would have extolled this as a prescription for better economic growth. Unanimously, the job shedding and downsizing was deplored as part of a vicious circle of self-reinforcing deflation.

The point is that these slash-and-burn strategies ultimately hollow out and weaken economies if they are not associated with significant new investment. Just as fallacious is the view that these measures ensure abnormally high profits at the expense of wages. As long as such actions remain limited in scale, it will undoubtedly help the participating businesses to improve profitability. But when it becomes epidemic, it squeezes purchasing power and ultimate profits.

The truth is that profits, like everything else, have considerably underperformed in this recovery. Several factors have contributed to the illusion that profits have been strong. To begin with, profits had fallen to all-time secular lows before the recovery began . . . in fact, even before the recession. Improvements from a low base are more likely to look large in percentage terms. More critical is the fact that bank and broker profits have made an enormous, disproportionate contribution to aggregate profit levels. Without this influence, what is revealed is that domestic non-financial profits are still near historical lows as a share of Gross Domestic Product (GDP). Although strong gains probably occurred in the fourth quarter of last year, there was no profit growth in the non-financial sector in the preceding nine months.

What we are witnessing are neither textbook recessions nor textbook recoveries. Weak cyclical forces are dwarfed by heavy structural maladjustments and imbalances that are the lagging legacies of the excesses of the 1980s. No, we don't think that the excesses of the past have dissipated yet. The root structural problems of all Anglo-Saxon countries remain prolonged overconsumption at the expense of investment and the trade balance. Because of this, as we've pointed out many times before, the Anglo-Saxon countries have ravaged their long-term growth potential. In contrast, Japan and Germany's structural root problem is overinvestment, which in the case of Germany has been complicated by the horrendous costs of unification.

THE LAGGING LEGACY OF PAST EXCESSES

Trying to untangle the forces at play currently, it's necessary to separate the short-term cyclical from the long-term structural trends. In all countries, sustained growth of output and employment depends entirely on the successful correction of structural maladjustments. In a stunning downward revision of earlier estimates, the Fed erased some 3.7% of U.S. industrial capacity last year in one fell swoop — slashing annual capacity growth between 1987 and 1992 from 2.4% to 1.7%. Lately, average capacity growth for this period has been revised down even further to 1.6%. Essentially, it's crucial to remedy this disastrous trend by higher capital formation and productive investment. But that requires rather more than just a cyclical recovery — namely, a massive reallocation of resources from consumption to investment in productive plant.

Presently, the Anglo-Saxon countries are perceived to be in the vanguard of the world economic recovery. In 1993, U.S. real GDP grew 2.9% and U.K. GDP grew 2%. Though growth was positive, it's important to know its composition. Just what role did the badly needed capital formation play?

Well, according to virtually all of the reports we read, the present U.S. recovery is excelling in regard to investment trends. We read this from an influential voice of consensus, Morgan Stanley: "*Capital spending in the U.S. has risen at an 11% annual rate since the middle of 1991 and has accounted for roughly half of the total gains in GDP during the current recovery.*" In like vein, many observers croon that an unprecedented boom in capital spending is taking place in the United States.

Our conclusions are diametrically opposite: The current U.S. economic recovery, despite its strong surge

during the fourth quarter, has remained unusually sluggish, mainly owing to profound, long-term weakness in fixed investment. During the first 30 months of this U.S. recovery, fixed investment overall rose in real terms by only 17.8%. That compares poorly with an average rise of 28% in the previous five cycles.

To review an important point we made in the last letter, what's worse is that capital spending is as lop-sided as never before toward one single category: information-related equipment (mostly computers). All other investment — home building, non-residential construction, and industrial equipment — are weak compared with past recoveries and, net of depreciation, are very near or below previous postwar lows.

Since early 1991 (the official end of the recession) computers accounted for literally 50% of the increase in fixed investment. The last letter gave a detailed explanation why these big computer expenditures grossly distort the GDP data on the upside.

As a cyclical demand component, sharply rising investment spending is crucial for its so-called multiplier effects on employment and wage income. These effects arise primarily in the industries that produce the capital goods. We said that spending on building has the biggest impact on jobs and incomes by far because it is most capital- and labour-intensive. All the money earned, less that portion saved, is in turn spent again, and so the spending cycle continues.

We fully share the admiration for the U.S. computer industry. However, the fact is that from a cyclical perspective, its impact on employment and incomes is virtually nil since it is meeting the soaring demand for its products with minimal additions in jobs and with plunging prices. Since the first quarter of 1991 through to the end of the third quarter of 1993, computers accounted for 18% of overall GDP growth. However, one should know that fully 74% of this stated GDP growth was due to a statistical adjustment for price cuts and increased computer power.

The more we study this, the more we realize that the U.S. computer industry grossly distorts the whole U.S. economic picture. Though accounting for only 2.6% of total manufacturing output, it has contributed one-third of total manufacturing productivity growth. While heavy computer investment has great merits, it's important to recognize its limited effects. It's no substitute for the type of investment that produces goods. And it's these types of investment that remain in a slump.

A FALSE DAWN IN BRITAIN

What about the widely-publicized economic recovery in Britain? Is it sustainable and what about its composition? Presently, Britain stands out from the rest of Europe as the one major country where the economy managed to grow last year. In the third quarter, real GDP had risen 2% year-over-year.

What's driving this U.K. recovery? It isn't investment spending. Total fixed investment has only risen 1.1% year-over-year, following a decline of 18%. This rise accounted for only 8.4% of GDP growth. It was consumption and government spending, accounting for more than 90% of overall growth, that drove Britain's recovery.

Meanwhile Britain's trade deficit has ballooned to £13 billion and the budget deficit has risen to £50 billion at annual rate (approximately 10% of GDP). Private sector credit growth, at 3% over the year, remains very low. These figures already reveal enough to conclude that the U.K. recovery is extremely ill-structured and destined to be aborted. For Britain it's definitely a false dawn.

WHAT TO MAKE OF SEEMING ECONOMIC RECOVERIES

The strong performance of the U.S. economy in the fourth quarter of last year apparently has put all of the doubters on the defensive. Early estimates put fourth quarter GDP growth at an annual pace of 5.9%. To gainsay such strong growth now would be to court laughter. Everyone is convinced that a self-sustaining recovery has finally taken hold in the United States. Yet, we still don't read or hear any convincing explanation as to why this upturn is the real thing and not just another false start. The fact that there have been at least three such false starts over the past three years alone argues for such a critical analysis.

We see a number of erratic and unsustainable items in the U.S. economic data — the effects of flood damage repair, a credit card borrowing spree, a wave of year-end purchases by business to take advantage of an expiring opportunity to deduct up to $17,000 against taxable income and a car sales boom, to name the major ones. As well, exports have added 1.6 percentage points to the fourth quarter increase. In a global recession, that trend is not likely to continue much longer. But all of these factors don't lead us to the main point.

Ultimately crucial in our assessment are the broader considerations — the identity of the underlying and prospective cyclical forces. Business cycles reflect interacting investment, credit and income cycles. Every single self-sustained, self-reinforcing cyclical recovery has been characterized by double-digit growth in fixed investment, credit and profits entailing strong growth in employment, productivity and consumer incomes.

None of that is evident in any of the Anglo-Saxon recoveries currently. We see nothing that supports the conclusion that these "cyclical dynamics" have kicked in. The inevitable conclusion is that economic momentum must soon wane. In fact, the real question is whether or not a renewed slowdown will develop into a serious relapse. If our view seems too incredulous to believe given the present burst of market euphoria, well, we can only say that facts and theory support our opinions. Time will tell. We certainly plan to be around to answer for our conclusions.

A COMING INFLATION OR DEFLATION?

Returning to the debate we opened earlier, we pointed out that one school of thought sees the present financial inflation eventually converting itself into a general price inflation in commodities, goods and services. If liquidity is overflowing on Wall Street, why shouldn't it spill over onto Main Street? Essentially, to put it into our terms, this group worries that the prevailing asset inflation — actually a narrow securities inflation — will give way to a price inflation. We strongly dissent with this view.

The favourite arguments supporting this argument are two: firstly, that excess liquidity will switch its attentions from overvalued financial to real assets; and secondly, that slow-growing production capacity will be unable to meet sharply rising demand given already high capacity utilization levels.

We fully agree with the concern that there is a dangerous lack of U.S. industrial capacity to meet a strong rise in demand. Capacity bottlenecks, resulting from many years of under-investment as we see in the United States today, have been the regular harbingers of inflation.

This time, though, there is a significant difference that changes the analysis. Given the very slow

economic growth relative to the strong capacity expansion in the rest of the world, there's a lot of under-utilized capacity out there that's ready to pounce on any rise in U.S. domestic demand. Instead of inflating domestic prices, rising U.S. demand would mainly inflate the U.S. trade deficit and could possibly trigger a dollar crisis. As a matter of fact, without the safety valve of surging imports, U.S. inflation would already be much higher than it is presently.

Yet, the main reason why we disagree with the inflation crowd is liquidity. The whole idea of a possible or even probable switch from financial assets into real assets is sheer illusion. It would necessarily involve a massive shift between two groups of "marketable" assets — from securities into real assets. That's very different from the present asset shift which is taking place from cash into securities. Few people seem to realize that these two flows have diametrically different effects on the financial system.

A flight from cash causes a boom; a flight from assets causes a crash. That's the key and crucial difference. The reason that's so is because money invested in non-liquid, marketable assets is permanently locked in. To get out again, the owner has to find a buyer who is willing to give up cash. And so, for the overall financial system, no flow of funds takes place, only a change of ownership. If too many investors want to sell, the market crashes, destroying all of the imaginary wealth and liquidity in its wake.

The dangerous fallacy in the general thinking is that booming markets reflect overabundant liquidity. As explained, the mania is really the product of rapidly declining liquidity. While new savings rates are still near secular lows in the United States, investors are unloading their liquid assets in favour of securities. To call this a liquidity-driven process is an absurdity, especially in the face of record-low broad money growth (M2, M3, and M4).

That leads us to the third and bleakest of the possible scenarios. Frankly speaking, this is the outcome that we expect will take place in some form. Its key premise is a continuing general sawtooth economic performance as the structural impediments drag on but only as long as the financial boom continues. The easy profits of the mania and its wealth effect have buoyed psychology and above all consumer demand. What will eventually sabotage this trend is bust of the financial boom. That is the greatest threat to world economic stability.

MONETARY MAKE-BELIEVE

For the U.S., there are two central facts: first, its economy is much weaker and more vulnerable than policymakers and the market consensus seem to realize: second, the present financial boom, having begun in late 1990, is not based on a healthy, sustainable foundation of higher savings and low inflation but the greatest and most frenzied financial speculation in history. Abnormally low short-term interest rates and excessive reserve injections by the Fed, rather than starting a genuine recovery in the normal way, have hyper-stimulated the financial markets.

Most observers exult about the resulting surge in stock and bond prices and condone it as the emblem of excellent policies. By contrast, in the 1920s, senior people in the Fed worried about the rampant speculation in the stock market and its likely aftermath. The main barometer of their concern was the rising valuation level. Apparently, today, Mr. Greenspan and the Fed are unreservedly pleased with the boom. Its wealth effects and the sharp decline in long-term interest rates are welcomed as stimulants to spending.

Then, what to make of the Fed's recent quarter-point hike in its Fed funds rate to 3.25%? We see a perverse logic at play behind this minor move. The view in the markets — a view obviously shared by the Fed — is that a mild signal of this kind would actually be bullish for the markets. While being too small to do any harm to the economy, by reacting to the slightest trace of inflation, the Fed is trying to convince the markets of its serious anti-inflation vigilance. This, it is hoped, will help to again lower long-term interest rates which backed up in recent months and inflicted heavy losses on the big yield-curve players.

Putting it plainly and simply, the Fed wants to rev up the speculative yield-curve play which has suffered the past few months because the banks stopped their bond buying binge. This isn't serious monetary policy at all. As we said at the start, it's monetary voodoo. What it does is stoke the speculative furnaces through anti-inflation make-believe.

We wonder whether this monetary trickery will work. It must have greatly surprised and even shocked the advocates of this play-act that the bond market's immediate reaction was very negative. Apparently, little does the Fed know that it is playing with fire. It is underestimating the precariousness of the financial bubble and overestimating the strength of the economy. As the historical record of past speculative bubbles shows, even little, quirky things can prick them. And if the Fed's actions inadvertently should serve as the catalyst for such a bust, it would play havoc with the world financial markets as well as the U.S. economy.

There is a complacent belief that the economy and its financial system are safe today, in contrast to 1929-30, because the Fed's low-interest rate policy has served to greatly strengthen the banking industry's balance sheet over the past three years. Supporting this notion is the misconception that the banking collapse of the 1930s, triggered by the brinkmanship of the Fed, was the major cause of the Great Depression.

That is the view perpetrated by Milton Friedman which has since become axiomatic in public opinion and most textbooks. Actually, the impact of bank failures in the 1930s was puny in comparison to the stock market losses. During the four years between 1930 and 1933, failed banks imposed losses totalling about $2.5 billion on stockholders, depositors and other creditors. By comparisons, the stock market crash wiped out an estimated $85 billion in capital values. Yet, Mr. Friedman concluded that the bank failures were crucial because *"they were the mechanism through which the drastic decline in the stock of money was produced."*

We have always subscribed to the opposite, minority point of view: that the stock market crash itself, rather than the bank failures, was the precipitating cause of the U.S. depression. To begin with, the wealth destruction caused by the stock market was incomparably greater. Last but not least convincing is the fact that the stock market crash lead the economy's slump whereas the bank failures followed, the first wave of closures having only begun in late 1930.

CONCLUSIONS

Looking at the world financial markets, we know one thing for sure: It's a frenzied, speculative bubble inflated by gigantic, unsustainable flows. The great general error in the accompanying complacency is to confuse the mass flight from liquidity with a condition of overliquidity. As reflected in the broad money aggregates around the world, liquidity growth remains dismal.

It's important to get a sense of historical perspective. While the media and the experts make it all sound so glorious and non-threatening, never before has the world witnessed a global mania of the proportions being experienced now. Never has a financial mania existed in such stark contrast to underlying economic conditions.

We think the speculative financial frenzy is the Damocles sword over the world economy just as it was in the 1920-30s.

The Fed is bluffing, wanting to gain the image of a stern inflation fighter. But though its rate hike amounts to no more than tokenism, it is taking enormous risks given the fragility of the financial bubble.

It's too early to say whether the Fed's recent action will have been a successful gamble in maintaining buoyant financial markets. The response of the U.S. bond market will be the litmus test. If it fails to recover, it will mean that the move is backfiring on the markets and the U.S. economy. And if U.S. stock markets fall out of bed, so will world stock markets.

Even though long-term bonds are exposed to less risk, they may suffer worldwide as well. To be on the safe side, always go with the currencies with the best liquidity. Though the dollar may get support over the short run, it will resume its long-term downtrend once markets awaken to the U.S. economy's weakness.

Given the inordinate risks in global financial markets presently, we see little worthwhile investment opportunities. Capital preservation is the overriding objective. Investors should only focus on cash securities and the shorter-term bonds of the hard currency countries, specifically Germany, Switzerland, Holland and Austria.

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